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TAGS: EAGR EAID ETRD ECON PGOV PREL SA
SUBJECT: IMPACT OF RISING FOOD/COMMODITY PRICES - SAUDI ARABIA

REF: A. 07 RIYADH 2529
¶B. RIYADH 373
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Classified By: Economic Counselor Robert B. Murphy for reasons 1.4 (b) and (d).

¶1. (U) Summary. Driven primarily by rising rents and food prices, inflation in Saudi Arabia hit a 27-year high of 8.7% in February. Rents are up 18%, food prices have risen 13%, and Saudi food imports increased 44% for the 12 month period ending in January. The Saudi government has announced various measures to battle inflation and implemented numerous food subsidies in an attempt to control prices. The efficacy of these measures is questionable given the difficulty of the SAG controlling monetary policy because of the riyal's peg to the dollar, and its unwillingness to limit government spending on long overdue and needed infrastructure, educational and health projects during an oil boom. End Summary.

Inflation Hits 27-year High

¶2. (U) Driven primarily by rising rents and food prices, inflation in Saudi Arabia hit a 27-year high of 8.7% in February. Rents are up 18%, food prices have risen 13%, and Saudi food imports increased 44% for the 12 month period ending in January. While heightened food prices in the Kingdom are chiefly attributable to the global rise in food prices, they are further boosted by retailers passing on rising rents to consumers and by the Saudi riyal's fixed peg to the declining U.S. dollar. Also, domestic agriculture has been impacted by skyrocketing fertilizer costs (up 300% since January) and recent bad weather. Poor weather in December negatively impacted domestic vegetable harvests which comprise 75% of vegetables consumed in Saudi Arabia. The recent rise in the cost of living has been an economic shock to Saudis who enjoyed inflation averaging less than 1% for the 15 years preceding the recent upsurge.

The SAG Responds

¶3. (U) On January 28, the Saudi Council of Ministers approved 17 measures to control rising prices and inflation in the Kingdom. The SAG will:

--add a compounding 5% cost of living allowance to the salaries of its employees for each of the next three years;

--increase social insurance benefits by 10%;

--decrease the level of indirect taxation (it does not

collect an income tax) by bearing 50% of the fees relating to passports, vehicle licenses and ownership transfers, and renewal of residence permits for domestic workers for the next three years;

--bear 50% of all port fees for the next three years;

--expedite construction of public housing;

--establish a national housing authority;

--enact a new mortgage law;

--continue to review prices of medicines;

--approve a supply policy that aims to diversify sources of supply of goods to ensure that local demand can be satisfied at reasonable prices;

--activate a law to promote fair competition and prevent monopolies;

--activate the role of the Association of Consumer Protection to monitor the market and enhance public awareness on market developments;

--combat trade fraud;

--require shops to place lists of products prices in a prominent place within stores;

--better coordinate consumer information campaigns; and

--continue to control the prices of basic commodities.

¶4. (U) On March 3, King Abdullah bin Abdulaziz al-Saud replaced Hashim Abdullah Yamani with Abdullah ibn Ahmed Zainal Alireza as Minister of Commerce and Industry (reftel). Yamani created an uproar in 2007 when he observed that the price of rice is governed by global prices (not the Saudi government) and consumers have a choice to buy cheaper rice. He was viewed by much of the Saudi public as inefficient and ineffective, and was blamed for high housing and food costs in Saudi Arabia. In contrast, Alireza, a highly successful businessman, has a solid reputation for achieving economic results. The Saudis are looking to him to rein in inflation.

Focus on Strategic Commodities

¶5. (U) Saudi Arabia suffered a shortage of wheat flour, one of its basic staples, for a six month period ending in March. The Kingdom achieved self-sufficiency in wheat production in 1985, and since has only imported small retail packs of flour and specialized baking flour. The SAG allocates wheat production quotas to farmers, purchases locally grown wheat at $266.67 per metric ton, and sets retail prices at $148.21 and $207.31 per metric ton for white and whole wheat flour, respectively. These low prices have not changed since 1985 and contributed to the three causes of the wheat shortage. First, large quantities of Saudi flour were smuggled to Yemen where the price of wheat flour has increased sharply. Second, local livestock owners began to use wheat flour as animal feed when the price of barley, the main camel and sheep feed in Saudi Arabia, reached $13.33/50 kilograms compared to $6.75/45 kilograms for white wheat flour. Third, local snack food producers increased the use of wheat flour to expand production and exports to nearby countries.

¶6. (U) In response, the SAG assigned more law enforcement officials to track down and arrest wheat smugglers, and is paying better attention to wheat flour distribution in the region where most of the wheat smuggling is carried out. Further, the SAG increased the import subsidy on feed barley, added seven additional animal feed ingredients to its imported animal feed subsidy program, revoked the licenses of

wheat flour distributors that sold wheat flour to animal farms and banned the sale of flour as cattle feed. The government is also considering ordering local snack producers to import wheat flour from the international market. The SAG has not indicated any consideration of addressing the root cause of the shortage (artificially low prices) by limiting its wheat subsidies. Wheat flour is now available at supermarkets at regular prices. A two kilogram bag of wheat flour costs $0.53.

¶7. (U) Rice, the Kingdom's second basic staple, is not grown domestically. Retail prices of imported rice increased from between 11% (for U.S. long grain parboiled rice) and 113% (for Pakistani white rice) from February 2007 to February 2008. In March 2008, the SAG began to subsidize rice imports at the rate of $266.67 per metric ton and increased the government subsidy of imported baby formula. All government subsidies paid on imported animal feed, rice and baby formula are paid directly to the local importer with the hope (but not requirement) that the savings will be passed on to consumers.

¶8. (U) On April 1, the SAG exempted wheat, wheat flour and other grains from import duties and reduced duties on 75 other foodstuffs to 5%. These foodstuffs include chilled and frozen poultry and their products, eggs, cheese, cheese cream, vegetable oils, pasta, canned meat, fruit and vegetable juices, mineral and ordinary water, long life milk, corn flakes, peas, beans, peanut butter, yeast and baking powder.

No Change in Monetary or Fiscal Policy

¶9. (U) The Saudi Arabian Monetary Authority (SAMA), the Saudi central bank, has made it clear that it is committed to the Saudi riyal's exchange rate peg to the U.S. dollar despite public calls for depegging. SAMA points to inflation in Kuwait as evidence that depegging the riyal will not serve as a quick fix for inflation. However, SAMA's adherence to the peg does require Saudi monetary policy to mirror that of the U.S. Federal Reserve despite divergent economic cycles in the Kingdom and in the U.S. SAMA has followed the U.S. Federal Reserve in reducing interest rates even though these cuts are expected to have negative consequences for inflation given that money supply growth in the Kingdom hit a 30-year high in January. The efficacy of SAMA's recent move to raise reserve requirements was blunted by this excess liquidity.

Despite the disadvantages of maintaining the peg as it currently impacts inflation, abandoning it would lead to a harmful contraction in Saudi wealth rather than easing inflation.

¶10. (C) In a recent meeting with EconOffs, Abdulrahman al-Hamidy, Deputy Governor for Technical Affairs at SAMA, stated that the SAG will principally address the consequences rather than the causes of inflation. He explained that government spending (most of the spending in the Kingdom) is focused on long-delayed investments in health, education, and basic infrastructure, as well as economic investments. These economic investments include new petrochemical plants, greenfield economic cities and Saudi Aramco projects. Such investments did not keep pace with demand in the fiscally-strapped 1980s and 1990s when oil prices were low. Al-Hamidy expressed concern that if the SAG curtailed these projects it might limit Saudi Arabia's future growth. He further explained that the SAG is not making cash transfers to poor Saudis because it would take government bureaucracy "a year" to accomplish this while the poor are facing higher rents and food prices now.

¶11. (C) On April 30, Ministry of Finance officials told Ambassador Fraker that inflation in the Kingdom had reached 10%, but that it was largely beyond government control since it was caused by global food prices and local construction bottlenecks. SAG officials confirmed that they are not

sterilizing oil revenues and that they fully understand that subsidies are not a long term solution for rising food prices. For a long-term solution, they added, SAG is looking to invest in agricultural production both at home and abroad.

Under Pressure

¶12. (C) Comment. The SAG is under public pressure to control inflation, particularly food and rent prices. The SAG's means to accomplish this are limited given that rising food prices are a global phenomena and the Kingdom is experiencing an oil boom. Further, the SAG's monetary policy is effectively set by the U.S. Federal Reserve, and there is little public support for cutting government spending. Inflation was a serious problem for Saudi Arabia during the last two oil booms and we expect it will continue to be a problem during the this one. However, we also expect the SAG will preserve the affordability of basic food items such as bread, rice and chicken. End Comment.
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